

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:F:MAN:4:POSTF-163566-01

CAMcInroy

date: *March 5, 2002*

to: Team Manager Michael Friedman, LMSB, Area 1 (Financial Services)

from: Area Counsel (Financial Services)

subject: [REDACTED]
Section 83 and 83(h) - Property for Services
UIL No. 83.01-00

This memorandum is in response to your request for assistance in determining whether certain warrants issued in connection with a settlement agreement are taxable income to the above-referenced taxpayer under I.R.C. § 83. As discussed below, we conclude that the warrants are compensation for services rendered and, as such, taxable under I.R.C. § 83; that the taxpayer's assignment of a portion of the warrants to certain individuals does not shift the tax burden to them; that the warrants are taxable in the year of exercise; and that the taxpayer may be entitled to a deduction to the extent that the individuals include a like amount in income. This memorandum should not be cited as precedent. This memorandum is issued under the provisions of Internal Revenue Manual 35.3.19.4, which allows a 10 day review period to the National Office. We request, therefore, that you delay taking action based upon this memorandum until we receive the National Office's response. We have, however, informally coordinated our advice with Norm Paul of the National Office.

ISSUES

(1) Whether the warrants issued in accordance with a settlement agreement are compensation for services rendered and, therefore, taxable income under I.R.C. § 83 to [REDACTED].

(2) If taxable to [REDACTED], whether issuing a portion of the warrants to two individuals shifts the tax burden to them.

(3) Whether the warrants are properly taxable in the year of receipt, [REDACTED], or in the year of exercise, [REDACTED].

(4) Whether [REDACTED] is entitled to a deduction under I.R.C. § 83(h) for the portion of the warrants issued to the

individuals.

CONCLUSIONS

(1) The warrants issued in accordance with a Settlement Agreement are compensation for services rendered and, therefore, taxable income under I.R.C. § 83 to [REDACTED].

(2) Issuing a portion of the warrants to two individuals does not shift the tax burden to them under the anticipatory assignment of income doctrine.

(3) The warrants are properly taxable in [REDACTED], the year of exercise.

(4) [REDACTED] may be entitled to a deduction under I.R.C. § 83(h) for the portion of the warrants issued to the individuals if the individuals include that amount in income.

FACTS

[REDACTED] (" [REDACTED]"), formerly known as [REDACTED], was formed to develop certain [REDACTED] technology.

[REDACTED] (" [REDACTED]"), a subsidiary of [REDACTED] ("the taxpayer"), is an investment banking firm.

In [REDACTED], [REDACTED] entered into a private placement agreement (" [REDACTED] PPA") with [REDACTED] to raise additional capital to develop its [REDACTED] into a marketable product. [REDACTED] anticipated three rounds of private placement financing with a new series of convertible preferred stock (Series [REDACTED], Series [REDACTED], and Series [REDACTED]) issued with each round. The [REDACTED] PPA provided that [REDACTED] would attempt to raise \$ [REDACTED] to \$ [REDACTED] through a private placement offering of [REDACTED] stock. For these services, [REDACTED] agreed to pay [REDACTED] a cash commission at the closing of the private placement equal to [REDACTED]% of the amount raised and to issue warrants to purchase [REDACTED] stock exercisable for a period of [REDACTED] years at a price of \$ [REDACTED] share. [REDACTED], with one exception, was to serve as the exclusive private placement agent for [REDACTED].

The [REDACTED] PPA was amended by letter dated [REDACTED] (" [REDACTED] PPA"), to allow a different venture capital firm to underwrite the first round of financing of the Series [REDACTED] shares and to allow [REDACTED] to serve as "exclusive placement agent" in connection with the second round of financing of the Series [REDACTED]

shares. [REDACTED] was to be paid a cash commission equal to [REDACTED] % of the amount raised and to be issued warrants to purchase Series [REDACTED] shares equal to [REDACTED] % of the shares it sold. The warrants were to be exercisable for a period of [REDACTED] years at a price per share equal to the offering price. The [REDACTED] PPA added a liquidated damage clause which provided that, if [REDACTED] did not proceed with the second offering, it would issue to [REDACTED] as liquidated damages a warrant to purchase up to [REDACTED] shares of Series [REDACTED] preferred stock for \$[REDACTED] per share. If warrants were issued as liquidated damages, the agreement would terminate and [REDACTED] would waive any and all claims it might otherwise have under the agreement.

In [REDACTED], in spite of [REDACTED]'s exclusive contractual right to underwrite the second round of financing of the Series [REDACTED] shares, [REDACTED] chose not to issue its Series [REDACTED] preferred stock through [REDACTED] and instead, another large venture capital firm closed the Series [REDACTED] offering. By letter dated [REDACTED], [REDACTED] terminated the [REDACTED] PPA by issuing to [REDACTED], in accordance with the liquidated damage clause, a warrant for [REDACTED] shares of Series [REDACTED] preferred stock.

[REDACTED] immediately returned the warrant and asserted certain claims under the [REDACTED]. Specifically, [REDACTED] maintained that the liquidated damage clause only applied if the sale of the Series [REDACTED] shares was abandoned altogether and since it had not been, it was entitled to the compensation that it would have been had it completed the offering. [REDACTED], by contrast, maintained that it was entitled to issue the Series [REDACTED] preferred stock through a different underwriter so long as it paid [REDACTED] in accordance with the terms of the liquidated damage provision, namely by issuing [REDACTED] shares of Series [REDACTED] stock.

In [REDACTED], [REDACTED] and [REDACTED] entered into a Settlement and Release Agreement ("Settlement Agreement") to resolve their dispute.¹ Under the terms of the settlement, the

¹ We note that, the Settlement Agreement indicates that the dispute between [REDACTED] and [REDACTED] arose out of the [REDACTED] PPA and the [REDACTED] PPA between the two parties, but the settlement refers to claims asserted under those agreements by [REDACTED], [REDACTED], and [REDACTED] together referred to as "[REDACTED]". What claims or rights [REDACTED] and/or [REDACTED] may have had under the private placement agreement between [REDACTED] and [REDACTED] are unknown. We note that [REDACTED], and [REDACTED] each owned [REDACTED] stock. [REDACTED], is an investment company owned solely by [REDACTED]. [REDACTED] is an investment banker who also owns [REDACTED] % of [REDACTED].

PPA was to be terminated and (or its designees) was to receive a warrant exercisable for an aggregate of shares of Series preferred at \$ per share, exercisable for a period of years. The warrant was to be issued to or its designees. At 's request, on or about , issued separate warrants to (for shares), (for shares), and to (for shares). also agreed to pay \$ to as reimbursement for legal fees, and the parties agreed to a general release of all claims.

Following a stock split in , the warrants for shares were converted into warrants exercisable in the aggregate for shares at an exercise price of per share.

On , and exercised all of the warrants for the purchase of shares of stock, which at that time had a fair market value of \$ per share. Checks in the total amount of \$ were paid to .²

On days later, went public. the mean selling price per share on that date was \$. claimed a deduction on its corporate income tax return in the amount of \$ representing the fair market value of all of the stock on the date the stock went public, which date was days after the warrants were exercised. issued a Form 1099-MISC in to in the amount of \$ even though a portion of the warrants were issued directly to and .

maintained that it was entitled to the deduction under I.R.C. §83(h) because it was an ordinary and necessary business expense under I.R.C. §162. The LMSB Attorney from Philadelphia advised the IRS that the deduction should be disallowed because stock transferred by a corporation to a financial expert for underwriting services rendered in connection with a private placement agreement, as here, are capital expenditures. The LMSB attorney further advised that the fair market value of the warrants must be determined on the date of exercise, , not on the date that the stock went public ().

² We note that paid \$ for the purchase of stock with a check drawn on the account of " .

); that the total value of the stock on the date of exercise was \$ (x \$ (per share) - \$ (amt. paid)); and that that amount must be reported in . A copy of that advice dated and is attached.

The individuals, and , initially failed to report any income in connection with either the receipt or the exercise of their warrants. It appears that in and filed amended returns for reporting \$ and \$ of income, respectively, with respect to receipt of the warrants. It is our understanding that these individuals reported capital gain income received in connection with their subsequent sale of the stock they had purchased under the warrants.

Like , these individuals also maintain that the warrants were not granted for services performed but, rather, in connection with the settlement of a breach of contract claim. Hartford SB/SE is handling the audit of the individuals. On January 16, 2002, in response to a request for legal assistance from the Hartford Office, the National Office issued field service advice wherein it advised that, under the rules of I.R.C. § 83, the warrants were transferred to the individuals "in connection with the performance of services;" that the warrants did not have a "readily ascertainable fair market value" when they were granted; and that, consequently, the individuals must recognize compensation income under § 83 when they exercised the warrants in , which was the date on which they were transferred beneficial interests in the shares purchased under the warrants. A copy of the field service advice dated January 16, 2002 prepared by Norm Paul is attached.

Similarly, , the taxpayer in the instant case, received a warrant to purchase shares in and exercised its right on . also initially failed to report income from receipt of the warrants on either the date of receipt or the date of exercise. In , filed an amended return for the taxable year and reported \$ with respect to the receipt of the warrant.³ also did not report any income with respect to the

³According to a recent IDR response, advised that its management valued the warrants taking into consideration comparables of other private companies in similar situations in terms of business and stage of development, newness to the market, investment risk factors and the terms of the warrants and determined that the fair value was \$ per share. We note that has not provided the IRS with comparables.

exercise of the warrant because, it alleges, the warrant was not issued for services that were performed. [REDACTED] maintains that the warrant was issued in settlement of a breach of contract claim and, therefore, was not a compensatory option subject to I.R.C. § 83. [REDACTED] further advised that gains of approximately \$[REDACTED] with respect to the subsequent sale of the shares received upon exercise of the warrants were recognized in [REDACTED]. [REDACTED] did not claim a deduction in connection with the warrants issued to the individuals.

We believe that warrants issued in accordance with the settlement agreement are compensation for services and as such are taxable under § 83. Furthermore, we believe that the full amount of warrants is taxable to [REDACTED] as an anticipatory assignment of income in the year of exercise but that [REDACTED] may be entitled to a deduction for amounts paid to [REDACTED] and [REDACTED] if those individuals include a like amount in income.

1. Section 83 - Property for Services

Section 83 governs transfers of property in connection with the performance of services.⁴ Generally, section 83 provides that property transferred "in connection with the performance of services" is included in the gross income of the transferee in an amount equal to the excess of the fair market value over the amount paid for the property transferred. This section is applicable to the transfer of any property, including stock and stock options,⁵ to employees and independent contractors in connection with the performance of past, present or future services. Alves v. Commissioner, 734 F. 2d 478 (9th Cir. 1984), affg. 79 T.C. 864 (1982). The property need not be transferred

⁴Section 83(a) provides that, if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property, on the first day that the rights to the property are either transferable or not subject to a substantial risk of forfeiture, over the amount paid for the property is included in the service provider's gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture.

⁵ We believe the term "option" as used in section 83 and the regulations thereunder includes warrants such as the ones issued by [REDACTED] in this case. See Shamburger v. Commissioner, 61 T.C. 85, 90 (1973), aff'd. 508 F.2d 883 (9th Cir. 1975).

by the person for whom the services are performed for section 83 to control. Treas. Reg. section 1.83-1(a)(1).

In the instant case, [REDACTED] and [REDACTED] entered into a private placement agreement in [REDACTED] which was amended in [REDACTED]. These were legally binding contracts that required [REDACTED] to perform underwriting services and required [REDACTED] to transfer cash and warrants to [REDACTED] for the performance of such services. In the event that [REDACTED] failed to use [REDACTED] as the placement agent for the offering, [REDACTED] was also obligated to pay [REDACTED] as liquidated damages a warrant for underwriting services that were performed and that could no longer be performed.

As it turned out, [REDACTED] failed to use [REDACTED] as its placement agent for the second offering, thereby triggering the liquidated damage provision obligating it to issue a warrant to [REDACTED] as compensation for underwriting services it had performed and for the services it no longer could perform. Although a dispute arose over the amount and type of compensation, the resolution of the dispute did not alter the character of the payment. Under the [REDACTED] PPA, [REDACTED] was obligated to issue to [REDACTED] a warrant to purchase up to [REDACTED] shares of Series [REDACTED] preferred stock for \$[REDACTED] per share as liquidated damages. Whereas, under the settlement agreement, [REDACTED] agreed to issue [REDACTED] (or its designees) a warrant to purchase [REDACTED] shares of Series [REDACTED] preferred stock at \$[REDACTED] per share. Clearly though, under both agreements the warrants were transferred to [REDACTED] in connection with the performance of services and, as such, must be included in the gross income of [REDACTED].

Our determination is consistent with the National Office's position with respect to the tax treatment of the individuals. The National Office determined that, on the same facts, there was a significant relationship between the services to be performed under the private placement agreements and the warrants that were to be granted under those agreements; that granting warrants as liquidated damages did not change the fact that both the warrants and the liquidated damages grew directly out of the private placement agreements; that the shares purchased under the warrants were "transferred in connection with the performance of services;" and that, therefore, the warrants were compensation income includible in the taxpayers' gross income under I.R.C. § 83.⁶

⁶The National Office also points out that other facts consistent with this determination include the following: paragraph #1 of the Settlement Agreement states that the parties

2. Anticipatory Assignment Of Income

Having determined that the warrants are taxable income under § 83, the next issue is how much must be included in [REDACTED]'s gross income.

In this case, [REDACTED] directed [REDACTED] to issue a portion of the warrants directly to [REDACTED] and [REDACTED], as permitted under the terms of the Settlement Agreement. Issuing a portion of the warrants directly to these individuals, however, does not shift the tax burden to them. We believe that directing payment in this manner was an anticipatory assignment of income and, as such, [REDACTED] must include the full amount of the warrants in its income.

Generally, under the anticipatory assignment of income doctrine, a taxpayer who earns or otherwise created a right to receive income will be taxed on any gain realized from it, if the taxpayer has the right to receive the income or if, based on the realities and substance of the events, the receipt of the income is practically certain to occur, even if the taxpayer transfers the right before receiving the income. Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999); Kinsey v. Commissioner, 447 F.2d 1058, 1063 (2d Cir. 1973); Estate of Applestein v. Commissioner, 80 T.C. 331, 345 (1983); Lucas v. Earl, 281 U.S. 111, 114-115 (1930).

It is well settled that an entity earning the income cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity. United States v. Basye, 410 U.S. 441 (1973); Caruth Corp. v. United States, 865 F.2d 644 (5th Cir. 1989) (one who earns income cannot escape tax upon the income by assigning it to another). "If one, entitled to receive at a future date... compensation for services, makes a grant of it by anticipatory assignment, he realizes taxable income as if he had ... received the salary and then paid it over." Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958).

acknowledge that except for provided in this agreement "no compensation is due to [them] under [the private placement agreements] or any other agreement"; the [REDACTED] PPA refers to the warrants to be granted to [REDACTED] as "agents warrants"; section [REDACTED] of the [REDACTED] PPA provides that "[REDACTED] will have [REDACTED] days (the "Placement Period") to sell all of the Offered Shares" and refers to [REDACTED] as [REDACTED]'s "agent" in the private placement; and the Settlement Agreement refers to what happens if [REDACTED] "fails to sell" the shares.

In the instant case, [REDACTED] and [REDACTED] entered into legally binding contracts that required [REDACTED] to transfer cash and warrants to [REDACTED] for underwriting services performed. Although the Settlement Agreement resulted from a breach of the [REDACTED] PPA, it did not alter the purpose for issuance of the warrants, namely, for services performed or that should have been performed. Essentially, under the Settlement Agreement, [REDACTED] had the right to receive a warrant to purchase [REDACTED] shares of Series [REDACTED] preferred stock for \$ [REDACTED] per share instead of [REDACTED] shares Series [REDACTED] preferred stock for \$ [REDACTED] per share and it could designate in writing who it desired to receive the warrant(s). At [REDACTED]'s request, warrants were issued to [REDACTED] and [REDACTED] entitling each to purchase [REDACTED] shares, respectively. Because [REDACTED] had the right to receive the warrant to purchase [REDACTED] shares and because an assignment of a fixed right to income does not shift the incidence to taxation to the recipient(s), [REDACTED] must include in income the full amount of warrant(s), even though a portion of the warrant was assigned by designation to [REDACTED] and [REDACTED].

3. Year of Inclusion

[REDACTED] maintains that, if § 83 applies, then the value of the warrant on the date of grant ([REDACTED]) is the amount of income that it must included. We believe, however, that since section 83 applies and there is no ascertainable value on the date of grant, the warrants are taxable as compensation income on the date of exercise ([REDACTED]).

Section 83(e)(3) provides that section 83 does not apply to "the transfer of an option without a readily ascertainable fair market value." See also Treas. Reg. § 1.83-3(a)(2). The value of an option without a readily fair market value is includible in income on the exercise or disposition, rather than the grant of the option. Treas. Reg. § 1.83-7(a); see Commissioner v. LoBue, 351 U.S. 243, 249 (1956); Robinson v. Commissioner, 82 T.C. 444 (1984); Adair v. Commissioner, T.C. Memo. 1985-392.

Options generally have no readily ascertainable market value when granted unless the option is actively traded on an established market. Treas. Reg. § 1.83-7(b)(1). The options in this case were not so traded. Nonetheless, section 1.83-7(b)(2) provides:

...if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions

exist:

- (i) the option is transferable by the optionee;
- (ii) the option is exercisable immediately in full by the optionee;
- (iii) the option or the property subject to the option is not subject to any restriction or condition which has a significant effect upon the fair market value on the option; and
- (iv) the fair market value of the option privilege is readily ascertainable in accordance with paragraph (b)(3) of this section.

In the instant case, at the time of the transfer, the warrants were neither publicly traded nor traded on an established market. They were issued only as part of private financing transactions and, as such, were subject to securities laws restrictions concerning their transfer. Accordingly, since the requisite conditions set forth above did not exist when the options were granted, the difference between the fair market value of the shares on the date of exercise, [REDACTED], less the amount paid on exercise, or \$ [REDACTED], must be included in [REDACTED]'s income.

4. Section 83(h) Deduction

Section 83(h) allows the person for whom the services were performed a compensation expense deduction under section 162 or 212 in an amount equal to the amount included in the gross income of the person who performed such services. The deduction is allowed for the taxable year of the such person in the year in which the amount is included in the gross income of the person who performed such services. No deduction is allowed to the extent that the transfer of property constitutes a capital expenditure.

In the instant case, on its [REDACTED] corporate income tax return, [REDACTED] claimed a deduction in the amount of \$ [REDACTED], the fair market value of the stock issued to [REDACTED] and the individuals on the date the stock went public. The LMSB Attorney correctly advised that expenses incurred by a corporation in connection with the sale of stock to raise capital, as here, are nondeductible capital expenditures. Steinberg v. Commissioner, T.C. Memo. 1983-534 (stock transferred to financial expert for underwriting services performed were nondeductible capital expenditures); Levinson v. Commissioner,

T.C. Memo. 1997-95 (payment under settlement agreement arising out of option to purchase corporate stock was nondeductible).

Nonetheless, we believe that [REDACTED] may be entitled to a deduction limited to the value of the warrants issued to the individuals. [REDACTED]'s assignment of a portion of the warrants to the individuals may be viewed as a transfer of property for the performance of services and taxable under § 83. If the individuals, as service providers, include the value of the warrants in income then [REDACTED], as the service recipient, would be entitled to a deduction equal to the amount included in the individuals' income.⁷ [REDACTED], however, is not entitled to a deduction until the such individuals include the corresponding amount in income. Since to date they have not done so, no deduction is allowed.

Nor can [REDACTED] take advantage of the "safe harbor" provision contained in Treas. Reg. § 1.83-6. That section allows an employer to deduct compensation paid to an employee through a transfer of property in the year that the corresponding income is includible in the employee's income if the employer deducts and withholds income tax on the payment under I.R.C. section 3402. [REDACTED] neither reported the payments to the IRS nor withheld any income on such payments. See Venture Funding, Ltd. v. Commissioner, 100 T.C. 236 (1998) (taxpayer denied § 83(h) deduction where it had not issued Form W-2 or Form 1099, and no employees included value of stock in income).

Consistent with National Office advice with respect to the individuals, it appears that, on these facts, [REDACTED] and [REDACTED] should report compensation income in [REDACTED] in the amounts of \$ [REDACTED] and \$ [REDACTED], respectively, and

⁷Under the regulations, an employer may deduct the amount "included" in an employee's gross income; the amount included is the amount reported on an original or amended return or included in gross income as a result of an IRS audit of the service provider. See Treas. Reg. § 1.83-6(a)(1); see also T.D. 8599.

⁸We note that the Notice of Exercise dated [REDACTED] for the [REDACTED] shares issued to [REDACTED] directs that the share certificates be issued in the name of "[REDACTED]" and that the check paid on exercise was drawn on the account of "[REDACTED]." We do not know whether [REDACTED] sold his warrants to the partnership or simply transferred his rights by assignment without consideration. We have been advised that the partnership did not report any income in connection with the stock. Nevertheless,

that [REDACTED] should report income in [REDACTED] in the amount of \$ [REDACTED].⁹ If the individuals collectively report \$ [REDACTED] in [REDACTED] then [REDACTED] should be allowed a deduction under § 83(h) in that amount in [REDACTED]. Since the individuals have not reported any income in [REDACTED], and the full amount is properly taxable to [REDACTED] in [REDACTED], the IRS should adjust [REDACTED]'s return and assert a deficiency on the full amount of the income of \$ [REDACTED].

Please contact Cheryl McInroy at (212)298-2069 if you have any questions or require further assistance.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ROLAND BARRAL
Area Counsel, LMSB
(Financial Services)

By: _____
THEODORE R. LEIGHTON
Associate Area Counsel, LMSB
(Financial Services)

this apparent transfer by [REDACTED] to the partnership in which he appears to have an interest does not change our determination that [REDACTED], individually, must include the value of the stock as compensation on the date of exercise.

⁹These amounts were calculated by taking the number of shares received by each multiplied by value on date of exercise (\$ [REDACTED]) less the amount paid on exercise (amount of shares x [REDACTED]).